

# NAVAL POSTGRADUATE SCHOOL MONTEREY, CALIFORNIA



## THESIS

**IRAN TODAY:  
FUNDAMENTALIST STRUCTURES OF  
GOVERNMENT AND GROWTH**

by

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September 1997

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AND GROWTH**

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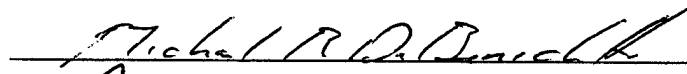
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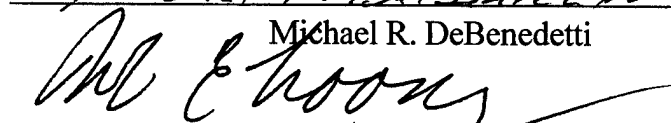
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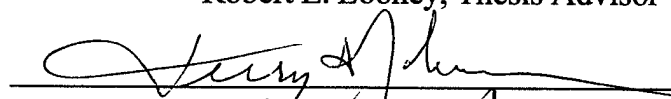
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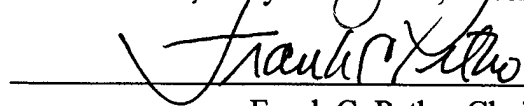
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## **ABSTRACT**

Despite eighteen years of effort to establish a quasi-democratic fundamentalist regime, Iranian elections saw the crushing defeat of the ruling elite's candidate. This election result represents a popular call for a change in direction for the Islamic regime. Iran is not alone in their battle to reconcile fundamentalist religious doctrine and progression into the Twenty-first century. Tradition based economies and their requisite structures of government are relevant throughout the world today. With few exceptions these systems have been unable to produce states with effective economies. Without a sustainable growth rate in the economy, dealing with the almost universal population explosions seen in these fundamentalist based systems is proving impossible. Frequent meddling in the economy and social fabric of the nation to try and influence market driven outcomes seems to leave these structures of government destined for revision. This thesis applies recent advances in the theory of structures of government to produce valuable insight as to the likely direction of change in Iran.



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## EXECUTIVE SUMMARY

Despite eighteen years of effort to establish a quasi-democratic fundamentalist regime, Iranian elections saw the crushing defeat of the ruling elite's candidate. The election of Seyyed Mohammad Khatami to the presidency indicates a profound disillusionment with the results to date of the Islamic revolution. Khatami, a dark horse in the election process because of his ouster from the Ministry of Culture in the early 1990's, was swept into office with 70 percent of the popular vote. His landslide victory should be interpreted as a clear signal that the people of Iran are looking for government that is less intrusive in their private lives, is better able to manage the economy, and provides a rising standard of living to match the growth in population. Iran is not alone in its battle to reconcile fundamentalist religious doctrines and progress. Still its extensive application of fundamentalist principles provides a unique insight to the difficulties of these systems.

Clearly, many differences in fundamentalist based systems could be attributed to differences in religious theology. Less obvious is the proposition that the application of economic theory concerning structures of government and economic growth often provide equally valuable insight. The main proposition developed in this thesis is that by separating the complex questions of religious theology and management of the economy, it becomes possible to see how fundamentalist systems have the potential for success.

Theologians in fundamentalist systems often contribute significantly to economic and social chaos. They attempt to "reform" government structures according to religious dogma. This thesis argues that a religiously based government has not much sympathy or understanding of such secular affairs as economics and law. Only by scientific control of the economy and by encouragement of a legal system under which a government is held accountable, can the validity of a fundamentalist society be maintained. It is further argued that the effects of stability and growth on the economy of a fundamentalist regime will benefit its transition to a market-based structure under a centrally planned system. This transition is both profitable and important for long term growth in today's global marketplace. It is perhaps Western oriented to apply the concept of economic growth as an appropriate measure of

economic success. However, there seems to be no other accessible measure which can be applied across cultural lines with hope of measuring the benefits of sound government structures which lead to economic success.

To develop these propositions, this thesis provides the reader with a general analysis of fundamentalist based systems including the major, recognized, religious systems of Buddhism, Confucianism, Hinduism, Judaism, Christianity, and Islam. From this examination, a focus on the specifics of Islam is included to allow a better understanding of the difficulties facing fundamentalist systems. While this thesis chose Islam to represent the generalities of fundamentalist systems because of its sweeping implementation in Iran, there are few reasons that analysis of any of the fundamentalist systems implemented as thoroughly, would not provide similar findings of the use of social control to achieve religious goals. The current Western perception of fundamentalist systems is that these systems are unique and relatively unimportant to the West. To mediate this perception it is important to understand Iran and its potential for success.

Economic theory dealing with the importance of sound, stable structures of government is designed to establish an environment suitable for investment. Stable environments which lead to economic growth are a critical element of this thesis. This theory is used to identify differences in government structures which may lead to or detract from economic growth. The importance of credibility to stability is illustrated in discussion of the time consistency problem. Further, the ability to classify the structures of government and the importance of establishing a rule of law system is presented. The absolute necessity of subjecting governments to law is another point which may be argued. For who would want to rule a system in which one has no control? This thesis argues that it is not a complete subjection to the law of the system which is required for success, rather it is the establishment of some limitations on the power of a ruler. Ironically, from these limitations, credibility can be enhanced as economic stability and growth are achieved.

The next probable crisis in Iran is likely to be found in the nation's youthful population increase. This expanding segment of society is already taxing the social structures of government. As these youths age, they will create an even greater burden for the government's social welfare programs. The solution to the existing and likely worsening economic stagnation seems to be a move toward establishing economic stability through market structures of government. Current developmental theory suggests a correlation between government structures and elements of economic stability. While the specific impact of religion and leadership on these developments may be debated, this thesis argues that there are conclusions to be drawn as to the likely evolution of political and economic systems. These conclusions suggest the cohesiveness displayed by Iran during its debt crisis in 1993 was not unique and when necessary, support for extreme policies can be achieved. Regime credibility is established by arriving at consensus, while the implementation of strict social policies serves to further enhance this credibility. Economic stability is founded on credibility, good structures, transition, and growth.

In summary, while separation of the institutions of religion and government is desirable in terms of establishing economic stability, it is not entirely a requisite. A credible move towards restricting the ruling elite's ability to influence market events at will should suffice to encourage investors that Iran is on the right track. A firm commitment to the principles of free markets today, while holding its own challenges in the future, may allow Iran to avoid a failed economic system in the future. As Iran represents the most thorough implementation of fundamentalist structures, this thesis suggests that other fundamentalist systems are likely to apply any lessons learned.



## ACKNOWLEDGMENTS

Dedicated to my Grandfather,

Thomas Wyman Riley

February 09, 1915 - October 17, 1988

After serving as a beachmaster in World War II in both California and Alaska, he was recalled to serve as the Press Officer for testing of the atomic bomb at Bikini Atoll. He attained the rank of Lieutenant Commander, United States Navy and following his active duty service remained dedicated to a life of public service. Politically active in his home district of Solono County, California until his death, his work as a District Representative for five serving U.S. Congressmembers, availed his experience and insight to many. He was directly responsible for my enlistment in the Navy and though he did not survive to see my Commissioning, I'm sure he would be proud of all that has been accomplished.

I would like to thank my thesis advisors, Prof. Looney and Prof. Johnson, for taking the time to provide their inputs and helping me clarify my thoughts. I would also like to thank those people with whom I have served that made me do things right, which is not always easy, but always worthwhile. Finally, I would like to thank my wife Michelle and our daughter Isabella for reminding me why it is we do the things we do, my family for their support over the last 35 years and, of course, the Navy for giving me the chance.





## I. INTRODUCTION

"If men were angels, no government would be necessary."

James Madison

President of the United States

Recent elections in Iran point to a new direction for the revolution and the nation. The election of Seyyed Mohammad Khatami to the presidency indicates a profound disillusionment with the results to date, of the 18 year old Islamic revolution.<sup>1</sup> Khatami was a dark horse in the election and had not often been mentioned in Western press accounts of the election process because of his ouster from the Ministry of Culture in the early 1990's by the powerful religious elements in the government.<sup>2</sup> His election can be attributed to several influences, all of which indicate dissatisfaction and disillusionment with both the structure and the practice of the government in Iran.<sup>3</sup> These factors include continued oppression by secret police forces, inefficient bureaucratic structures, rampant inflation, and a floundering economy.<sup>4</sup>

Khatami's election should be interpreted as a signal that the people of Iran are looking for a government that is less intrusive in their private lives, is better able to manage the economy, and provides a rising standard of living. This revamped government seems to have initiated a move towards an "inclusive" interpretation of Islam rather than the "exclusive" model that the clerics had been advocating.<sup>5</sup> Interpreting the new Iran will be addressed several times in this paper because of variations in perspective which have led to a variety of

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<sup>1</sup> Murphy, Paul, "Iran on the Rocks," *The Electric Library*, Vol. 12, January 01, 1997, p.100.

<sup>2</sup> Kaplan, Robert D., "Why the US and Iran Will Be Friends Again," *The Wall Street Journal*, February 10, 1997. See also Swindells, Steven, "New Iran President Faces Tough Economic Challenges," *Reuters*, May 05, 1997.

<sup>3</sup> Viorst, Milton, "The Limits of the Revolution, Changing Iran", *Foreign Affairs*, Vol. 74, No 6, November/December 1995, p. 68.

<sup>4</sup> Kaplan, "Friends Again," see also Murphy, "Iran on the Rocks."

<sup>5</sup> Murphy, "Iran on the Rocks," p. 100.

views on fundamentalist governments. As a consequence of these differing perceptions, many questions concerning the direction of Islamic fundamentalism remained unanswered. These unanswered questions have created economic confusion in Iran today.

This thesis argues that any system of government primarily based on religion is one that should also provide for the separation of church and state. This separation is important not only for the economic success of the country but also for the stability of its religious regime. To illustrate this point this paper looks at the rise of religiously based governments. Despite some similarities, they include some major deviations in their religious interpretations. This thesis, then, elaborates on the specifics of Islam, and the unique structures inherent in Islamic fundamentalism.

Current developmental theory suggests a correlation exists between government structures and elements of economic stability. While the specific impact of religion and leadership on these developments may be debated, this thesis argues that there are conclusions to be drawn. These conclusions suggest the cohesiveness displayed by Iran during their debt crisis in 1993 was not unique and when necessary, the regime can generate support for extreme policies. This, in turn, implies that Iranian fundamentalists are likely to demonstrate similar resolve when faced with their next crisis.

Iran is experiencing a huge increase in the nation's youthful population. Already a burden for government, as these youths age, they will create an even greater burden for social welfare programs. The solution to the existing and likely worsening economic stagnation seems to be a move toward establishing economic stability through market structures of government. While separation of the institutions of religion and government is desirable in terms of establishing economic stability, it is not entirely a requisite. A credible move towards restricting the ruling elite's ability to influence market events at will should suffice to encourage investors that Iran is on the right track. A firm commitment to the principles of free markets today, may allow Iran to avoid the potential civil strife associated with a failed economic system in the future.

Theologians contribute significantly to economic and social chaos. They attempt to reform government structures according to religious dogma. This thesis argues that a religiously based government has not much sympathy or understanding of such secular affairs as economics and law. Only by scientific control of the economy and by encouragement of a system of law under which a government is held accountable, can the validity of a fundamentalist society be maintained. It is further argued that the effects of stability and growth on the economy of a fundamentally based regime will benefit its transition to a market based structure under a centrally planned system. This transition is both profitable and important for long term growth in today's global marketplace. To apply the concept of economic growth as an appropriate measure of economic success is perhaps Western oriented, but there seems to be no other accessible measure which can be applied across cultural lines with any hope of measuring the benefits of sound government structures leading to economic success. Because of the perception of the potential impact of Islamic systems, it is important to understand, Iran, as one of the most influential of the fundamentally based Islamic systems of government and its potential for success.

Recent developments in theory associated with the structures of government and growth as applied to Iran will be the subject of this thesis. Application of this theory will illustrate some strong parallels to be found within fundamentalist systems and provide some suggestions for the future of these systems in terms of developing separate structures of government and religion. Finally, conclusions will be drawn in an attempt to form a prediction for Iranian society. It is hoped that this thesis will provide useful insight to the importance of the electoral result in Iran, some of the root causes for this significant vote, and what the future may hold concerning the direction of Iranian society and fundamentalist systems in general.



## II. NEW TRADITION BASED ECONOMIES

There is no question that the world is experiencing a rapid growth of organizations dedicated to establishing social, political and economic systems founded on specific principles of religion, often referred to as revivalist. While the rise of Islam is perhaps the best known, this lack of awareness does not slow the world-wide growth of fundamentalist systems based on Buddhism, Confucian, Hindu, Judaic and Christian principles.<sup>6</sup> These revivalist systems have been called the "New Traditional Economies" and appeal to a wide range of people for an equally wide range of reasons. It is argued that while these economies are based on tradition and principle, they are not in fact merely academic exercises or an attempt to live in the past, rather that they hold practical answers for real problems.<sup>7</sup>

The basis of revivalism does not seem to be the failure of market economics. There are many examples of nations with strong religious traditions that are very successful both in domestic and in international trade. Nor is there evidence that modern market economies discriminate based solely on religious dogma. Therefore, explanations for the growth in popularity of these new socio-economic systems must be found somewhere outside of the immediate realm of trade and market success. In fundamentalist societies, it is traditional institutions of religious beliefs, customs, and centuries of history that are the bedrock of society, not social or political theory.<sup>8</sup>

The ideals of religious equality and compassion are found in every fundamentalist based society. Despite these ideals, these societies face significant difficulties. They need to make the gradual evolution into a technical, materialist society without shedding their essential traditional and religious cultures. Fundamentalists tend to believe that a religiously oriented system of

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<sup>6</sup> Rosser, John Barkley, and Marina V. Rosser, eds., "Islamic Economics and the Economics of Other Religions," in *Comparative Economics in a Transforming World Economy*, (Irwin, Chicago, 1996) p. 101-108.

<sup>7</sup> Pfeifer, Karen, "Is there an Islamic Economics?," in Beinin and Stork (eds.), *Political Islam*, p. 157.

<sup>8</sup> Fabricio, Roberto, "Islam Defies Labels as Diversity Spreads Economically, Culturally," *Sun-Sentinel*, Fort Lauderdale Fla., April 16, 1995.

government should be able to care for all its citizens and still prosper. This ideal system has yet to be established. A review of fundamentalist systems codes of conduct and application of religion seem to bear this out.

#### **A. BUDDHIST**

Some Western writers extol the virtue of Buddhist economics and its "detachment from materialism and mindless economic growth."<sup>9</sup> The vision of Buddhism, common in the West, is one of a society which is harmonious, ecologically friendly, balanced in attitude toward work and relaxation. This vision may be attractive to many, though closer analysis reveals that the impact of such a harmonious vision on a world about to enter the twentieth century might be fraught with cultural shock and technological change.

In industrial China and Japan, which have a large percentage of the Buddhist population of the world, the societal role of Buddhism tends to be reduced to the passive support of market forms based on other principles of governance.<sup>10</sup> Nations in South and South-East Asia like Sri Lanka, Burma and Thailand, generally practice a form of Buddhism as the dominant religion and seem to incorporate some of the principles into their economics. Laos and Cambodia officially supplant Buddhism with socialist ideology, though Buddhist influence can be found in local communities.<sup>11</sup>

An insight into the differences in interpretations of religious text may be illustrated by review of one attempt to apply the principles of Buddhist economics. In Burma, the building of temples is a means of achieving individual merit. While overtly supporting a "Protestant ethic" style of motivation for accumulating wealth, success attained morally and within the principles of religious teachings is valued higher than that achieved materially. Because this wealth was made while following the precepts of Buddha, it is sanctified and holy. Ironically the policies of the Buddhist government concerning the appropriate use of such morally accumulated wealth

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<sup>9</sup> Rosser and Rosser, "Islamic Economics," p. 103.

<sup>10</sup> Ibid., p. 102.

<sup>11</sup> Ibid., p. 103.

effectively dissipated that wealth through poor capital investment activities. This squandering of capital resources provides little return to the economy while increasing the need for public and social services for both the religious and secular impoverished by an inefficient economy.

Results from Burma indicate a initial surge in investment generated by increased construction of temples. This was followed by low economic growth rates due to the non-capital investment nature of construction of religious shrines. This non-capital producing investment in turn has stagnated the economy and does not improve the quality of life for the population in general, though fundamentalist monks are better supported. The combination of low growth rates, increased expense and little capital return can mean only long term trouble for the policy and the regime.

## **B. CONFUCIAN**

The writings of Confucius are known throughout the world and are often thought of as the basis for a kind of philosophy or social influence rather than religion. Confucian values are unique in this discussion in that there is no major effort leading a call to return to fundamental interpretation of a text or clerical movement. Rather a call to return to the values of Confucius and not necessarily to the letter of his text has recently been echoed by many of the "Asian Tigers." These economies, noted for their rapid growth and ability to capitalize on rapidly changing circumstances, appear to have positioned themselves to continue into the future with sustained economic growth and prosperity. While the success of many of these economies is unassailable, the motivation for the call to return to Confucian values is often based on a desire to specifically counter the advancement of Western style ideals of equality, freedom and pursuit of happiness.

The Confucian values, so important to the leaders of nations as diverse as Singapore, Taiwan, China, Japan and Korea, include a strong reliance on order, hierarchy, education and benevolence. Application of the principles of market economics are generally accepted in these economies although many impose the strong arm of authoritarian structure and governmental control. Traditionally, Confucian thought emphasized a "hands off" approach to the structure



of markets as long as the leader was perceived to be properly benevolent, reverent and maintained celestial harmony. This enabled the prevailing government to confirm its authority and popular sovereignty by dispensing its economic benefits to the successful business entrepreneurs who in turn benefits the nation by the employment of workers and establishing efficient structures of commerce.

### **C. HINDU**

Mahatama Gandhi was responsible for the concept of independence for India, starting with his foundation of Hindu economics in "Hind Swaraj" in 1909. Gandhi envisioned a caste system purged of its worst elements and embracing an idea of self-rule and self-sufficiency at both the village and the state level.<sup>12</sup> He was able to establish an enduring emphasis on economic nationalism and self sufficiency. Despite this vision, Gandhi was a traditionalist in terms of economic policies, opposing industrialization, improved transportation, and urbanization. In fact, the spinning wheel became the symbol of this movement due to idealization of homespun cloth, indigenous village technology, and the nationalist independence (swadeshi) that it represented.

Following Gandhi's assassination, his followers moderated their views of Hindu economics to include less reform of the traditional caste system and greater acceptance of modern technology. These views were to remain in a decentralized framework as a system of modern, productive, small scale technologies in self-sufficient villages. This system is proving effective and India is often used to illustrate the positive effects of good economic planning and policies for the social welfare of a nation. India's successful application of Gandhi's principles for society, moderated by increased technological development, made for the gradual evolution of a traditional religious society of complex cultural values into the modern industrial giant that is India today.

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<sup>12</sup> Ibid., p. 105.

#### **D. JUDAIC**

Despite strong religious backgrounds and ardent adherence to the principles of Judaism the state of Israel, like other religious countries in the West is a secular one. The success of Judaic economics with its strong foundation in the Torah, should not be ignored. These elements include a list of specific injunctions concerning economic behavior, private property, and management of markets, which is not dissimilar to other religious based fundamentalist systems.

A distinguishing feature of the Judaic system is the strength of its institutions in terms of balancing radical and conservative elements of society. When religious values come into direct conflict with economic interests, a prohibitive mandate is not issued from the religious concerned. Rather the issue is resolved by mutual discussion by concerned governmental and religious groups.

The recent sale of the national airline clearly illustrates the effectiveness of this process. The issue at the heart of this sale concerned the appropriateness of the state of Israel to mandate work on the Sabbath. Due to scheduling requirements and differences in time zones, some of the air lines operations were conducted on the Sabbath. Meeting international business requirements imposed by the global nature of air travel were interpreted by some as a violation of the sanctity of the day. Though this linkage was distant and clearly beyond the direct control of the state, religious elements succeeded in pressuring the government to sell the airline.

Despite the political significance of this sale, fundamentalist religious elements effectively dictating governmental actions, there were no major changes in the stated goals of the government. There were no new policies which might impact operations of other segments of the economy. In general, there was little which might tend to scare off investors. Established structures in Israel allowed this decision to occur within the existing framework, so there were few opportunities for investors to develop perceptions of a lack of stability. Fixed rules, open discussions and opposition, little or no impact on other sectors of the economy, this

is practically a "text book" example of how a fundamentalist based regime should conduct business.

The benefit of developing these kinds of structures is readily apparent with a brief review of investment in Israel. During 1991-1995 investments in permanent assets rose an average of 13.5% a year.<sup>13</sup> Foreign direct investment in Israel rose from \$81 million in 1990, to more than \$2 billion in 1995.<sup>14</sup> Statistics from the National Authority for Economic Planning indicate an expectation of continued growth in the business sector's excess capital at more than 8% per annum through the end of the century.<sup>15</sup> This projected growth indicates that Judaic economic structures aptly demonstrate the ability of a system to incorporate radical fundamentalist elements while generating the economic benefits of relative stability.

#### **E. CHRISTIAN**

When dealing with the term "Christian" one must remember that it incorporates different branches of Christianity to include Catholicism and Protestantism. Both have factions which maintain differing views on the acceptability of market based economics as they exist today. The Catholic Church, while critical of excessive materialism and a lack of compassion for the poor, is generally thought of as pro-market. The Protestant church is linked even more closely with market capitalism both socially and ideologically.<sup>16</sup> Max Weber argued that "the Protestant ethic is the spirit of capitalism" due to early cooperation between the church and fledgling market institutions of capitalism.

While the two major representatives of Christian values are generally pro-market, there are a number of splinter groups which are not so benevolent towards the market. Differing intellectual views between some Catholic movements and also between a number of Protestant

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<sup>13</sup> Bar El, Rafi, "Growth from Peace," *Globes*, (March 29, 1996,) p. 1.

<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

<sup>16</sup> Rosser and Rosser, "Islamic Economics," p. 107.

organizations make it difficult to pull together a cohesive statement concerning Christian economics. For example:

“Strict” fundamentalists avoid discussion on politics and economics because they tend to distract from the immediate discussion of personal salvation.

The “New Christian Right” fundamentalists, often associated with Pat Robertson and Jerry Falwell, tend to be avidly pro-market.

“Christian Reconstructionists” tend to be more moderate theologically, but maintain radical libertarian economic views.<sup>17</sup>

The “Evangelical Left” in comparison, tends to support major government income redistribution, national food policies and guaranteed wages.<sup>18</sup>

“Radical Evangelicalism” represents the advocates of full blown socialism and the attendant government responsibility.

The breadth of differing views among these Christian groups, plus the variety in views of mainline Catholic and Protestant groups, make the true nature of Christian economics unclear without going to the theological depth of their respective faiths.<sup>19</sup>

## **F. ISLAM**

### **1. DIVERSITY**

A quick glance at the size of the Islamic world shows that with a population of some 1.6 billion and projections to exceed 2.0 billion by the year 2050, it represents the religious well-being of a large number of people. The core of the “Islamic Crescent,” containing some 32 nations, is in the Middle East and Persian Gulf region. Beyond the Crescent, Islam has been accepted as a dominant form of religion in nations as diverse as Sudan, Malaysia, Morocco, Nigeria and Tajikistan.

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<sup>17</sup> North, Gary, *Inherit the Earth: Biblical Principles for Economics*, (Dominion Press, Fort Worth, 1987).

<sup>18</sup> Sider, Ronald, *Rich Christians in an Age of Hunger*, (Intervarsity Press, Downer's Grove, Ill., 1977).

<sup>19</sup> Rosser and Rosser, “Islamic Economics,” p. 107.

As a religiously based system, Islam requires some flexibility to adapt to cultural differences, local practice and influences. There is little denial that the foundations of Islam provide this flexibility even though perceptions in the West often discount the potential of this positive aspect of Islam. Recent popularity of Islam as a foundation for a political system stems from several diverse issues concerning national identity, anti-colonialism, oil, and nostalgic remembrances of "Islam's glorious past".

Before delving into discussion of the general principles of Islam, it is worthwhile to note that the two main branches of Islam are that of the Shia and the Sunni. While both branches are found in Iran, the Shia branch is dominant.<sup>20</sup> While the principles of Islam remain fixed, application and interpretation of these principles vary significantly. Their interpretation is based on the dominant sect in the country and is important to our discussion because these differences greatly affect the structures of government in the respective nations.<sup>21</sup>

## 2. POPULATION

The population of Iran has grown from 37 million in 1979 to over 64 million in 1995.<sup>22</sup> While over 45 percent of the population is under 14 years old and there are about 7.5 million would be students in the age range from 13 to 17. This huge number of teens and preteens, combined with a increased trend of movement from rural areas to the cities and a falling per capita income points towards a catastrophic problem for the regime.<sup>23</sup> This paper contends that this population crisis may lead to yet another consolidation of consensus in the halls of power, not dissimilar to the consensus brought about by the debt crisis of 1993.

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<sup>20</sup> Viorst, "Limits of the Revolution," p. 67, see also Fabricio, Roberto, "Islam Defies Labels as Diversity Spreads Economically, Culturally," *Sun-Sentinel*, (Fort Lauderdale Fla., April 16, 1995).

<sup>21</sup> Fabricio, "Islam Defies Labels."

<sup>22</sup> Wright, "The Revolution Unravels," p. 1.

<sup>23</sup> Murphy, "Iran on the Rocks," p. 100.

This population crisis which many believe could prove to be the undoing of the regime is, in the opinion of this thesis, more likely to facilitate either a shift towards market oriented structures or retreat towards a radical socialist model.

### 3. FUNDAMENTALISM AND ECONOMY

The appeal of fundamentalist Islam is not only that it provides a set of moral codes by which to live, but that it also offers a system of economic and political organization of society.<sup>24</sup> This organization is distinct from both socialism and capitalism which are often considered the defining points of economic systems. As this paper has shown the realm of the new traditional economies present several options for development of economic systems though the "third way" presented by the Islamists seems the most fully developed.<sup>25</sup> As an alternative development strategy, some within Islam would like to successfully deal with the problems of both capitalism and socialism, while relying exclusively on neither.<sup>26</sup> This would be accomplished by adapting relevant principles of either system to a framework based on Islam.

An aim of establishing such a system of government would be to encompass competition within a socially responsible framework without losing the responsiveness of the markets.<sup>27</sup> In theory, from this framework a system of neither free trade nor autocratic protectionism, but "managed" competition would emerge.<sup>28</sup> This framework proposed by Islamic thinkers is not conceptually far from recent economic theory on the structures of government and growth. Major differences are found in the complete reliance on government structures rather than market forces to ensure a sound economy. Islamic government

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<sup>24</sup> Rosser and Rosser, "Islamic Economics," p. 114.

<sup>25</sup> Rosser and Rosser, "How do we Compare Economies," p. 6.

<sup>26</sup> Pfeifer, "Islamic Economics," p. 156.

<sup>27</sup> Ibid., p. 156.

<sup>28</sup> Ibid., p. 156.

structures are supposed to ensure adherence to the theological precepts of Islam, which it is argued, will then ensure success of the system.<sup>29</sup>

A point that most theorists tend to miss is that instead of looking like neither capitalism or socialism, an Islamic “third way” would tend to look like a combination of both. As we know, the structures of government incorporated into capitalism and socialism are not unique or distinctive. In some cases, the difference is only the political affiliation of the elected leadership. A significant problem in the potential success of Islamic economics as well as other fundamental economic systems, is the fact that much of the text on which the economic system is based is open to contradictory interpretation.<sup>30</sup>

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<sup>29</sup> For further examples, see Mehmet Ozay, *Islamic Identity and Development: Studies of the Islamic Periphery* (Routledge, New York, 1990) and Abdul-Hamid Abu-Sulayman, “The Theory of the Economics of Islam; Abdul Hadi Ghanameh, “The Interest-less Economy”; and Muhammad Al-Nowaihi, “Fundamentals of Economic Justice in Islam,” in *Contemporary Aspects of Economic Thinking in Islam, Proceeding of the Third East Coast Regional Conference of the Muslim Students' Association of the United States and Canada* . (American Trust Publications, Indianapolis, In., 1976).

<sup>30</sup> Valibeigi, “Islamic economic Policy Formation,” p. 802.

### III. ISLAMIC RELIGION

#### A. PRINCIPLES

Though there are many unifying elements in Islam, it is fair to say that implementation in terms of the structures of government varies greatly. This is in spite of universally accepted principles which provide general guidance for followers. Three broad principles, Tawhid, Kahilafah and Adalah, are further elaborated upon by six specific injunctions which arise and are interpreted from four general sources. A brief discussion of the meaning and importance of these elements is presented below.

Islam includes the notion of "Tawhid" or the singularity of God. In addition to indicating the "oneness" of God, it has also been interpreted as the unity of God and creation, which is the manifestation of God's power in the universe.<sup>31</sup> Some populist advocates extend the domain of Tawhid to social and economic phenomenon by arguing that the unity of God and creation also means equality of all men in the society. This is often where some scholars of Islam and advocates of socialism join paths.<sup>32</sup> Khilafah or vice-regency, implies that humans operate as partners of Allah in the management of the world and its resources. This further implies universal brotherhood, a concept stressed frequently in the Koran and the Hadith.<sup>33</sup> Adalah or justice, implies concern for the welfare of others and establishes cooperation as a basic principle of economic organization.<sup>34</sup>

Specific injunctions which dictate compliance to a fundamentalist Islamic system of economics include the principles of Zakat (alms giving), Riba (the prohibition on interest),

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<sup>31</sup> Valibeigi, Mehrdad, "Islamic Economics and Economic Policy Formation in Post-Revolutionary Iran: A Critique," Vol. 27, *Journal of Economic Issues*, September 01, 1993, p. 795.

<sup>32</sup> See Bahram Nowzad's review of Jahangir Amuzegar, *Iran's Economy Under the Islamic Republic*, (I.B. Tauris, New York, 1993), in *Finance and Development*, June 1994, p.50.

<sup>33</sup> Rosser and Rosser, "Islamic Economics," p. 107.

<sup>34</sup> *Ibid.*, p. 114.



Qirad (profit sharing), and Gharar (the avoidance of chance). Proper consumption, hard work and fair dealings are the last two major injunctions.<sup>35</sup>

Part of the difficulty in establishing a uniform code from which to enforce these injunctions is apparent just in the descriptions of each injunction. What is proper consumption? Does it vary with socio-economic status? How about availability? How hard is hard work? Is the degree of difficulty measured in calories burned per day, such that a day laborer is working harder than an mechanical engineer? If chance is to be avoided can there be risk takers? Can new ideas and products be brought to market? The theological questions are many and answers usually begin with, "It depends".

While the application of the general principles transcend national borders, they are found in one form or another in all Islamic based economic systems. Despite the near universal presence of these principles, like interpretation of Shari'a, implementation and penalties for noncompliance vary significantly. Variations in the frequency of enforcement and severity of penalty, extend into many other areas of the structures of Islamic systems and contribute to the apparent lack of overall success for the revolution in Iran.

## **B. LAW**

There are four sources of Islamic laws. The Koran is the first and most important for all Muslims. The second source of Islamic law, the Sunna, is based on the Hadith or the record that Muslims follow to learn about the practices of the Prophet.<sup>36</sup> The Sunna itself describes the tradition of the Prophet Mohammed his words and statements, acts and customs.

The third source of Islamic laws is Ijma. This constitutes legal issues on which Muslim jurists have reached consensus during a specific period of time.<sup>37</sup> We would use the concept of

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<sup>35</sup> See "Islamic Economics and the Economics of other Religions," in *Comparative Economics in a Transforming World Economy*, eds. J.B. Rosser and M.V. Rosser (Irwin, Chicago, Ill., 1996) Chap. 5, pp. 101-124. See also Muhammed Nejatullah Siddiqi, "Muslim Economic Thinking: A Survey of Contemporary Literature," in *Studies in Islamic Economics*, ed. K. Ahmad (Islamic Foundation, Leicester, 1980) p. 191-315.

<sup>36</sup> Rosser and Rosser, "Islamic Economics," p. 114.

<sup>37</sup> Kandil, Magda, "Islamic Economic Systems." *Domes*, 1995.

case law. Ijma is a complementary problem-solving tool to supplement provisions in the Koran and the Sunna.<sup>38</sup> Modern jurists view Ijma as the mechanism to adapt Islamic laws to changing conditions and an evolving society. The Ijma serves to keep the Shari'a applicable to changes and developments without undermining the fundamental divine basis.<sup>39</sup>

The forth source of Islamic law is the Shari'a. It is to direct men along the proper path. Revealed to the Prophet Mohammad as the proper code of conduct, it constitutes the commands of God and, therefore, is not subject to human reason or interference. Shari'a is intended to provide society with a collection of laws. Compliance to these laws establishes the Islamic sovereignty of a state.

The interpretation of Islamic law which declares man unable to interpret God's word or the Shari'a is a area of some concern to Islamic theologians. Strict application of this interpretation would tend to deprive the clerics of their exhalted and sometimes claimed divine inspiration in terms of establishing conditions for man's salvation. While this concern is of varying importance in different nations, it does point once again to the problems inherent when fundamentalist religious texts are used to govern.

Returning briefly to the concept of Shari'a, there are different interpretations of Shari'a followed by different nations. These interpretations vary based on the influence of the dominant Islamic sect and the religious scholars within that sect. Though placing emphasis on different issues, they are in fact establishing Shari'a and adherence constitutes an Islamic state. These differences become structural in nature and reach beyond the mosque into the government where most long term economic problems appear to reside.

### **C. BANKING**

Attempts to apply the principles of Islam to the management of economy are not new in the Islamic world.<sup>40</sup> Islamic banking, which is often defined as interest-free banking, is

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<sup>38</sup> Ibid.

<sup>39</sup> Ibid.

<sup>40</sup> As Behdad [1989] and Rahnema and Nomani [1990] have noted, the so-called Islamic economics is an

practiced today in Muslim countries such as Saudi Arabia, United Arab Emirates and Egypt.<sup>41</sup> The recurring problem with successful implementation of Islamic banking concerns interest. There are interpretations of the Koran which completely forbid the concept of interest. Though as in everything with an interpretation, there are others which suggest that the intent is not the elimination of interest, rather the avoidance of usury or excessive interest.

The debate over interest aside, Islamic banks need to make money for their investors or they do not remain in business. It is without consequence to the economic system if this profit is made through the rental of capital, or some other form of profit sharing rather than traditional forms of interest. The reality of the situation remains firmly rooted in the concept of accepting a profit for taking a risk. If a system develops other ways to describe this basic premise of investing, it does nothing to change the fact that investors crave stability and returns. Any system which can provide these two critical items will succeed.

The first experience in the era of international corporations and global communication was in Egypt in 1964 with capital supplied by West German banks.<sup>42</sup> The idea was initially supported by the Egyptian government, however, the expansion of Islamic banks came to a halt when political considerations ended support.<sup>43</sup> In Pakistan, during the presidency of Zia Al- Haq, Islamization of the entire banking system was suggested, but in practice, complete Islamization was narrowed to the creation of Profit and Loss Sharing (PLS) accounts offered in conjunction with conventional interest-bearing financial transactions.<sup>44</sup>

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eclectic combination of Islamic ethics and neoclassical theories of the capitalist welfare state. "This body of literature has increasingly become more sophisticated both in terms of its methodological approach and its theoretical complexity."

<sup>41</sup> Rosser and Rosser, "Islamic Economics," p. 119.

<sup>42</sup> Valibeigi, "Islamic Economic Policy Formation," p. 793.

<sup>43</sup> Rosser and Rosser, "Islamic Economics," p. 119.

<sup>44</sup> Valibeigi, "Islamic Economic Policy Formation," p. 793.

#### **D. PRIVATE PROPERTY**

Conflicting views of liberal and radical fundamentalists on the limits of private property and the role of the state in an fundamentalist economy conspire to undermine the formation of coherent economic policies in Islamic societies, including post-revolutionary Iran.<sup>45</sup> In general, it is considered structurally important to have established guidelines for the possession, acquisition and disposal of private property. Only through uniform application of this concept of private property can an economic system move towards establishment of markets. Markets require stability, predictability, credibility, and good structures of governance, in order to generate growth which is critical to social development.

#### **E. PATRIARCHAL SYSTEMS**

Patriarchal systems of government are hardly new to the scene, from the earliest days of history being a relative or descendant of the leader has frequently allowed significant advantages. Often times legitimacy for this authority is tied to a religious mandate. Patrimony is represented in a social organization reckoning decent from the male line of elders, empowered to perform the ordinances of a religion. To further clarify, patriarchal systems are similar to centrally planned systems in that the ruler, or ruling body, has essentially unlimited discretion in terms of choosing or altering a course of action.<sup>46</sup> Reliance on the unlimited authority of the leader bases the system on personal trust. The leader can hand out monopolies in property ownership, production, trade, etc.<sup>47</sup> Since the decisions of the ruler are the sole basis of legitimacy and direction of this system, there can never be complete investor confidence. Predictability is also subject to variance in application depending on the whims of the individual.<sup>48</sup>

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<sup>45</sup> Ibid., p. 793.

<sup>46</sup> Dhonte, et al. "Towards a Market Economy," p. 6.

<sup>47</sup> Ibid., p. 6.

<sup>48</sup> Ibid., p. 6.

The general nature of fundamentalist systems is so similar as to be interchangeable with the patriarchal system with the following exception. The individual patriarch is replaced with a group which functions as the patriarch in the fundamentalist system. This correlation between patriarchal and fundamentalist systems is further illustrated by the method in which fundamentalist systems maintain their position and autonomy in the structures of government. By maintaining superior knowledge of the theological questions of the particular fundamentalist systems, the clerics can evade imposition of enforceable rules by claiming that they rely on God for direction, and that there is no man who can claim to subject the word of God to human rules. Since they represent the message of God, they argue that they too cannot be subject to man's rules.

A problem may be that to subject themselves, the ruling clerics, to the rule of law has theological ramifications which they may not be able to reconcile. Through the linkage of authority and theological righteousness, the clerics in fundamentalist based systems have placed themselves in a precarious position. The unstable nature of their position is due to the inherent unsuitability of interpretive meanings of ancient texts for governing modern society. To clarify, if the interpretation of religious text changes, it could then change interpretation of religious law, which would alter the governmental structure. A change in the foundation of government could land those in power prior to such a change, out of the political picture.

## **F. ISLAMIC SOCIALISM**

While some scholars of Islam and advocates of socialism join ranks to embrace the notion of "Tawhid" or the singularity of God, populist advocates extend the domain of Tawhid to social and economic phenomenon. This partnership of Islam and socialism is not fixed in history or tradition. In practice, a historical review of Islamic society and Iran would illustrate particular adeptness in business and trade.

Today the economic goals of Iran's Shia influenced interpretation of Islam and its goals concerning economic structures echo those of fundamentalist systems in general. These goals

include establishing just prices and wages, ensuring distribution is widespread, limiting windfall profits of middle men, and adhering to principles of morality as described by their religion. While the specific note or the goals of the systems may vary, the overriding tenor is a need to assert or reassert national identity.

Proponents of these fundamentalist systems hold the belief that some cost in terms of efficiency, growth, and social limitation is acceptable in order to function in a manner that is as consistent as possible with religious beliefs. A salient problem with this is that religiously trained elite's, proponents of these systems, do not generally understand market mechanisms or the importance of allowing these mechanisms to work. By frequent interventions and revisions in an attempt to produce desired outcomes, they typically limit investment, growth, development and economic success.

Discussion of fundamentalist attempts to exercise more influence on social and economic issues in society leads to the necessity of a review of such practice to evaluate its success or identify its problems. Naturally, a system with a good record is desirable. Also a system which has had limited intervention from other forms of governmental and economic systems during its development would be beneficial. Both of these issues point to the suitability of a review of Iran.



#### IV. FUNDAMENTALIST IRAN

While Iran may be somewhat of an anomaly in Islam, this does not deter the dominant Shia religious element from clamoring for leadership in the supposedly destined wave of Islamic regimes.<sup>49</sup> Iran is trying fulfill its perceived role as the model of a successful Islamic system in terms of economics, politics, and social structures despite their many problems.<sup>50</sup>

After the advent of the Iranian revolution in February 1979, the new Islamic state launched a comprehensive program designed to apply the concepts of Islamic law directly to society. While the revolution had no clear specific economic goals, an objective of the revolution was to establish structures of government required to lay the foundation of an Islamist economic system in Iran.<sup>51</sup> The uniqueness of the Iranian experience, compared to earlier efforts to establish fundamental religious economies, was the scope and intensity with which it was embarked upon. Comprehensive programs directed at all levels of the structure of Iranian society were established by the revolution to implement and enforce fundamentalist interpretations of Islamic law.<sup>52</sup>

##### A. GOALS OF THE REVOLUTION

The primary motivation of the revolution, it is fair to generalize, was the religious perception that society had become Westernized. This shift towards Western values was perhaps the early movement towards the establishment of a more open market system under the Shah. However, the clerics found this distasteful because this meant focusing less on upholding the precepts of Islam than pursuing individual liberties which might include accumulation of consumer goods.<sup>53</sup> Additionally, the unpopular conduct of the Shah of Iran

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<sup>49</sup> Viorst, "Limits of Revolution," p. 76.

<sup>50</sup> Ibid., p. 76.

<sup>51</sup> Valibeigi, "Islamic Economic Policy Formation," p. 793.

<sup>52</sup> Rosser and Rosser, "Islamic Economics," p. 112.

<sup>53</sup> Viorst, "The Limits of the Revolution," p. 72.



provided the necessary figurehead for the revolutionary elements to oppose in order to generate popular opposition. This opposition would eventually topple the regime.

Implementation of the new Islamic focus on fundamentalist economics included various programs such as the "Cultural Revolution," "Islamization of the Judicial System" and "Islamization of the Economy." The latter included the application of Islamic law to land ownership and tenure, banking, labor relations and wages, inheritance, and even foreign investment.<sup>54</sup> This application of Islam to structures of the economy included the forced nationalization of critical firms and direct public control over major industries, including transportation, utilities, oil production, etc. These early goals of the revolution in Iran have undergone great changes in the intervening 18 years. Today structures are little different, and often perceived as worse than they were prior to the revolution.<sup>55</sup>

## **B. CHARITABLE FOUNDATIONS**

The structure in Iran following the revolution has placed great power and enormous wealth in the hands of semi-public charitable foundations.<sup>56</sup> These foundations, called Bonyads, are set up to operate appropriated business for the benefit of various groups in Iran which fall under such blanket descriptions as "the oppressed". In practice, though government owned and under control of the clerics, these Bonyads have come to operate largely outside of government control and accountable to no one.<sup>57</sup> The largest of these foundations, Bonyad Mostazafan va Janbazan, "The Foundation for the Oppressed and Injured", has grown to become 5 times as large as all other foundations combined and the largest conglomerate in the

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<sup>54</sup> Valibeigi, "Islamic Economic Policy Formation," p. 793.

<sup>55</sup> Wright, Robin, "In Iran, the Revolution Unravels; Economics, Not Ideology, Is The Islamic Republic's Biggest Threat As Disillusionment Spreads From The Downtrodden To The Middle Class. Khomeini Brought A Taste Of The Good Life, But Its Since Gone Sour." *Los Angeles Times*, Part A page 1, December 02, 1994.

<sup>56</sup> *Islamic Republic of Iran-Recent Economic Developments*, IMF Staff Country Report No. 95/121, the (International Monetary Fund, Washington, D.C., December 1995) p.46.

<sup>57</sup> Barraclough, Colin, "Despite Tradition of Trade Iran has few Entrepreneurs," *The Christian Science Monitor*, April 09, 1997, p. 8.

Mid-East.<sup>58</sup> Currently, Iran has only about 14 percent of its GDP in private control, about 1.5 percent of that is controlled by the Bonyad Mostazafan va Janbazan.<sup>59</sup>

What is significant is that Bonyads and other state run banks and industries receive some 62 per cent of allocated expenditures, while these industries have a reputation for inefficiency and corruption they, according to President Rafsanjani, "intend to be profitable".<sup>60</sup> The mechanism which allows the government to continue these excessive expenditures on poorly run businesses with little or no motivation to return a profit is a manipulation of exchange rates. By devaluation of the currency every year and increasing revenues by domestic sale of part of its "dollar oil revenues" at the official exchange rate of IR. 3000, revenues can be manipulated to appear to meet expenses.<sup>61</sup>

The government of Iran, by encouraging their growth or not moving to control these foundations, exhibits behavior consistent with a patriarchal system. That is attempting to stabilize the system by the granting of monopolies.<sup>62</sup> By allowing these foundations to monopolize industries and access "sweetheart" exchange rates, the government has greatly reduced competition in the limited private sector.<sup>63</sup> Additionally, because fellow clerics are in control of these foundations, often decisions are often made only to benefit the foundation rather than the society as a whole.<sup>64</sup> This shortsightedness contributes to the perception of instability and therefore serves to erode investor confidence, which contributes to a lack of growth.

In the case of Iran, the clerics do not appear to have an interest in establishing market structures, since they control a significant share, some 85 percent of the GDP through the

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<sup>58</sup> Ghoreishi, "Iran Circumvents Containment," p. 21. See also IMF Report No. 95/121, p. 46.

<sup>59</sup> Ibid., p. 23, IMF Report No. 95/121, p. 46.

<sup>60</sup> Allen, Robin, "Iran: Creative Budgeting the Rule," [www.usa.ft.com](http://www.usa.ft.com), January 30, 1997, p. 2.

<sup>61</sup> Ibid., p. 3.

<sup>62</sup> Barraclough, Colin, "Despite Tradition of Trade Iran has few Entrepreneurs," *The Christian Science Monitor*, April 09, 1997, p. 8.

<sup>63</sup> Ghoreishi, "Iran Circumvents Containment," p. 21, see also IMF Report No. 95/121, p. 46.

<sup>64</sup> Barraclough, "Iran has few Entrepreneurs," p. 8.

Bonyads, government run businesses, and banks.<sup>65</sup> They have little desire to limit their ability to ensure the profitability of these economic units in society. While some may choose to take the high moral ground in this argument, which is that the proceeds go to assist those in need, the reality appears to be that continued, random meddling in the economy by implementation of policies designed to assist these specific elements of the economy, significantly deters long term investment and its attendant growth.

### C. IRAN'S SOCIALISM

The manner in which the revolutionary government in Iran moved towards the accomplishment of their goals was in keeping with a generally socialist framework. Control of major enterprises with an impact on the public, such as foreign trade, banking, transportation, and power distribution, was seized by the government for direct control. Other critical firms were nationalized and placed into foundations for the benefit of the oppressed and downtrodden in society. Some redistribution of land was initiated though never completed which was perhaps a pivotal point in a socialist agenda.

The actions of the leaders of the revolution showed a particular level of naiveté in terms of reaching their economic goals of independence from the West: equitable distribution of wealth and resources, and an improved standard of living. Believing that the moral superiority of their religious beliefs would provide them the necessary depth of talent to radically alter the manner in which a nation's economy worked, seemed shortsighted in retrospect.

In fact, by failing to adopt established systems of government based on the existing models already described in this thesis, the revolutionaries failed to establish a stable regime by trial alone. Today finds the existing system of government in Iran continuing with the same inefficient economy.

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<sup>65</sup> Allen, "Creative Budgeting," p. 3.

#### D. PRIVATE PROPERTY IN IRAN

Despite support found in Khomeini's "A Clarification of Questions," which provides the official view on economic policy in Iran, application of the concept of private property varies. Khomeini is generally moderate in terms of economic views, supporting the notion of private property, as well as accepting land rents, sharecropping, and insurance. This relatively principled view of the structure of the economic system however, did not prevent the seizure of property belonging to the former royal family and associates in 1979.

These seizures, despite being contrary to the stated views on property rights, were in keeping with Khomeini's calls for redistributive justice and denouncement of corruption in the previous regime. The opportunity to issue economic and social decisions which appeared to contradict policy interpretations, contributed significantly to problems associated with the potential success of Islamic economics as practiced in Iran.<sup>66</sup> These conflicting views of liberal and radical fundamentalists on the limits of private property and the economic role of the state in the economy contribute to undermine the formation of coherent economic policies in post-revolutionary Iran.<sup>67</sup>

At the heart of the problems in Iran seems to be the lack of understanding of some, intuitive and academic basics concerning operational concepts of economics and the structures required to support these systems.<sup>68</sup> Part of the responsibility for this lack of understanding could likely be attributed to the Iranian perception that the problems of development and developing economies, and then be directly linked to the West and its expanding, often overwhelming values through the global internet of communications.<sup>69</sup>

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<sup>66</sup> Valibeigi, "Islamic Economic Policy Formation," p. 802.

<sup>67</sup> Ibid., p. 793.

<sup>68</sup> Beedham, Brian, "The Cash Flow of God," *The Economist*, Vol. 332, August 06, 1994, p. 8. To quote one bright Malayan banker, "If the scholars of the Koran had economic degrees, they would understand what they are trying to do."

<sup>69</sup> Viorst, "Limits of Revolution," p. 675.

This, almost diametric opposition to the importance of a market based structure, whether based in the West or East, is a major stumbling block for the clerics in Iran.<sup>70</sup> The leadership of Iran has effectively strangled investment, limited development and modernization, and delayed the benefits of economic stability to the people of the nation by their apparent push towards socialism.<sup>71</sup> Socialism or centrally planned economies has the appeal of perceived equality to fundamentalists. It is the reality of trying to make these systems work which they find overwhelming.

At this point in the turbulent history of Iran, it is not clear that its leaders have come to terms with the modern world of instant communication and mass-markets. To achieve this, they must understand the dynamics of a viable government structure where they can reconcile with fundamentalist principles of their Islamic faith - as indeed some of their regional neighbors have done.

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<sup>70</sup> Though not necessarily the President, see King, A., "The Revolution that Lost its Fizz," *The Economist*, Vol. 319, May 11, 1991, p. 38 for a discussion on Rasfanjani's early record in office.

<sup>71</sup> Wright, "The Revolution Unravels" see also Beedham, "The Cash Flow of God ."

## V. STRUCTURAL THEORY

Structures of government are important to the long term growth of a nation because, through these structures, a nation may establish a secure environment in which to conduct business.<sup>72</sup> Conversely by looking at these same structures investors may see signs of instability and choose not to invest. The long term effects to the nation of both the impression these structures convey to investors, and also the efficiency and predictability of governmental actions, are far reaching.<sup>73</sup> The two broadest generalizations that can be made about structures of government are to classify them as "good" or "bad".<sup>74</sup> The former creates an atmosphere for sustained long-term economic growth, and the latter is associated with inefficiency and corruption. Conditions of political stability, or expectations of such, tend to decrease risk for investors, improve the potential for profits, and form a base for economic growth. On the other hand lack of stability and danger of war are a sure recipe for deterring investors.<sup>75</sup>

### A. STRUCTURES LEADING TOWARDS GROWTH

Efficient law and order as well as macroeconomic and political stability form the core of these structural elements.<sup>76</sup> Law and order is critical because protecting society from both domestic racketeering and external threats is a basic function of government. Macro-economic and political stability allow investors a reasonable expectation of playing under fixed or at least semi-fixed rules.<sup>77</sup> Finally, though no less important, is the perceived credibility of the government. If the investor feels as though the government cannot be trusted, then they are

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<sup>72</sup> Dhonte, Pierre, and Ishan Kapur, "Towards a Market Economy: Structures of Governance." *International Monetary Fund*, WP/97/11, December 1996, p. 2.

<sup>73</sup> Dhonte, et al. "Towards a Market Economy," p. 1.

<sup>74</sup> *Ibid.*, pp. 9 - 10.

<sup>75</sup> Bar El, "Growth from Peace," p. 1.

<sup>76</sup> Dhonte, et al. "Towards a Market Economy," p. 12.

<sup>77</sup> *Ibid.*, p. 11.

likely to look elsewhere. If a system of governance cannot protect its people from external threats and the possibility of internal abuses, then it is not likely to attract investors who require a stable business environment.<sup>78</sup>

The importance of good, secure, accountable structures of government can not be underestimated. Not only is the population directly affected by these structures during their daily routines, these same governmental actions and policies directly effect domestic and international trade by indicating an either stable or unstable governmental system.

## **B. STRUCTURES DETRACTING FROM GROWTH**

From an investors viewpoint, the effects of an unsecured environment due to 'bad' structures of governance fall into two undesirable categories. The first is that they lower the expected rate of return on investments and, worst case, could lead to a seizure of assets. Second, dispersion of possible outcomes from investment is increased. This increase in the breath of possibilities for the results of investing reduces certainty and predictability, reductions unpopular with investors. Recent research has suggested that these two effects are not independent, rather they are additive.<sup>79</sup> Increased dispersion of outcomes has an adverse effect beyond simply lowering expectation of the rate of return. When these negative effects are balanced against the investors decision to wait, they have the effect of raising the threshold rate of return required prior to committing to investments in the nation.<sup>80</sup> By increasing uncertainty, a lack of economic security reduces the threshold rate of return and decreases the rate of investment.

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<sup>78</sup> Ibid., p. 10.

<sup>79</sup> Ibid., p. 2.

<sup>80</sup> Severn, Luis, "Irreversibility, Uncertainty, and Private Investment: Analytical Issues and Some Lessons for Africa," *The World Bank*, May 1996.

### **C. CREDIBILITY**

Formal integration of the concept of government credibility into economic analysis is a fairly recent event which was accomplished through the use of game theory.<sup>81</sup> To illustrate, if player A feels that he is at risk of predatory behavior by player B, he may choose not to invest and both would be worse off than if they could agree on limits to B's predatory behavior. This scenario does not require B to actually follow rules if established, rather that A must believe that he will. Though, if player B chooses not to follow established guidelines it is likely that A will withdraw and become suspicious of attempts by B to encourage A's return.<sup>82</sup> So, it is not enough for a government to propose "good" policies. The implementation and even proposal process must be structured in such a manner that investors believe that they are credible.

### **D. THE TIME CONSISTENCY PROBLEM**

In some cases, a situation may arise where a government may have to reconcile a "time consistency" problem enroute to establishing credibility. The essence of this problem is that the passage of time affects the appropriateness of the policy. For example, "the optimal policy following the establishment of credibility is not the same as it was prior to establishing credibility."<sup>83</sup> A policy imposed to counter inflation may result in a requirement to then reduce real wages and cut unemployment. The only way out of this dilemma is for the government to surrender some discretionary policy making tools and to be subject to binding rules. The importance of these limitations on government action is that by ensuring predictability of the actions of governments, investors can be assured of consistency of action, therefore the security of their investments. Since consistency supposes predictability, both become important in establishing credibility, and therefore become key issues of economic decision making.

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<sup>81</sup> Dhonte, et al. "Towards a Market Economy," p. 4.

<sup>82</sup> Ibid., p. 4.

<sup>83</sup> Ibid., p. 4.



## **E. CLASSIFICATION**

Discussion about credibility, consistency and predictability is directly related to the ability of a system of government to establish a secure environment. Recent empirical research clearly points to the influence of economic and political stability on real GDP growth.<sup>84</sup> Research completed by Borner, Brunetti and Weder, points to the dominant factor in determining the wealth of nations to be the “quality of their institutions and economic policies.”<sup>85</sup>

Economists have established methods with which to evaluate economies in terms of security, security which leads to stability, stability which leads to economic growth. Weber in 1978 used a distinction of patriarchal and bureaucratic based systems.<sup>86</sup> While this distinction may be blurred in actual practice, it is valuable for this thesis to present a clear vision between systemic differences in types of structures.

## **F. RULE OF LAW SYSTEMS**

These systems are generally based on stripping the ruler of discretionary powers and establishing a foundation of law from which the ruler is required to operate. Hayek in 1944 describes the rule of law system: “... this means that government in all its actions is bound by fixed rules and announced beforehand-rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in a given circumstances and to plan one’s individual affairs on the basis of this knowledge.”<sup>87</sup> To the investor this means that the system of government is interested in establishing a secure environment in which to invest and providing the investor the ability to plan their future business actions.

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<sup>84</sup> Hadijimichael, M., and Dhaneshwar Ghura, “Public Policies and Private Savings and Investment in Sub Sharan Africa: An Empirical Investigation,” *International Monterey Fund*, WP/95/19, February 1995.

<sup>85</sup> Borner, Silvio, Aymo Brunetti, and Beatrice Weder, *Political Credibility and Economic Development*, St. Martin’s Press, 1995.

<sup>86</sup> Weber, Max, *Economy and Society, Vol. II*, University of California Press, Berkeley, 1978.

<sup>87</sup> Hayek, F.A., *The Road to Serfdom, 15th Anniversary Edition*, (The University of Chicago Press, Chicago, 1944).

Limiting government's ability to establish economic security by granting monopolies or otherwise forcing artificial economic or social controls clearly increases predictability of the system. Further, establishing structures which clearly define limits for the behavior of patriarchs, either singular as in the case of a monarchy, or plural as seen in the case of Iran, gives the system structure. This structure when established and enforced will serve to further improve predictability, which increases credibility and investor confidence, and therefore establishes a secure environment conducive to growth.



## VI. TRANSITION THEORY

Now that we have an understanding of the two general types of economic systems that exist, we can address the method and importance of transition from one to another. Hopefully, the desired transition will be from a centrally planned to a market based system. This transition is not just a move from one structure to the other, or a move from more to less government. Rather, despite common misperceptions of the inverse linking of a states involvement in the economic system to the quality of its institutions and economic performance, the goal is to balance the markets and government.<sup>88</sup> How much government is appropriate? It is accurate to say that "better" economic policies are those that limit predation, both public and private, impartially enforce contracts, and ensure the long-term security of property rights.

### A. SOLVING THE TIME CONSISTENCY PROBLEM

There are two driving forces which influence the transition from patriarchal to rules based systems and they both coincide with an effort to develop individual liberties. The first challenge is to deal with is the "time-consistency" problem. In order to solve this problem, the ruler actually has a vested interest in subjecting himself to the rule of law.<sup>89</sup> By establishing credible limitations on predatory powers, a ruler both increases predictability and investor confidence. A great paradox exists in the practice of market system economies due to an inaccurate perception of the role of government in the system. Rather than the perceived "ideal" market system in which it is generally accepted that there is little or no government intervention, in reality, a market system heavily depends on the quality of its institutions.<sup>90</sup>

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<sup>88</sup> Stiglitz, Joseph, *Wither Socialism?*, (MIT Press, Cambridge, 1994).

<sup>89</sup> Bates, Robert H., "Institutions as Investments," Plenary Paper presented at the AERC Biannual Research Workshop, May, 1996.

<sup>90</sup> Dhonte, et al. "Towards a Market Economy," p. 7.

## **B. INDIVIDUALISM AND EQUALITY**

The second challenge faced by Islamic patriarchy in transition to a workable democracy is the ideological push for individualism and social equality to go with it. This ideological movement emphasizes social equality as a defining social value, one that will become recognized as information about democratic values becomes more widespread with global communication of modern technology.<sup>91</sup> Previous regime efforts to establish prestige will give way to the increasing importance of more basic values like infrastructure development and stable prices. They will take precedence over local, regional, and international quests for power and the necessity to establish or maintain regime legitimacy.<sup>92</sup> Most structures of government are established in an attempt to reconcile some of the inherent differences which exist when a group of people choose to reside together and form a society. Though rarely a foundation for government, the elimination or lessening of the impact of these societal differences is often a goal of government structures.

## **C. INCOMPATIBLE ELEMENTS**

Important elements of market systems which act independently to enforce adherence to the rule of law include transparency and accountability, both of which are incompatible with longevity of the patrimonial regime. This incompatibility results in a critical dilemma in the quest to establish structures leading to the development of market systems. The primary element of this dilemma is that efforts to establish structures which would limit a regimes' discretionary power are met with stiff resistance. The transition to a bureaucratic or rule of law system are antagonistic to existing regimes and often seen as an all or nothing proposition. The impact of this all or nothing mentality, often found in patriarchal systems, is that rather than encouraging a system of government which has a vested interest in the health and prosperity of the economy, it is aggressively opposed. This opposition is founded in the belief that market

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<sup>91</sup> Oakeshott, M., *Morality and Politics in Modern Europe*, (Yale University Press, New Haven, 1993).

<sup>92</sup> Dhonte, et al. "Towards a Market Economy," p. 8.

systems would tend to discourage religious values and undermine support for the religious in the structures of government.

While it may seem that this occurs predominately in market systems, it is certainly not exclusive to these systems. Strong opposition, in fact attempts at elimination of religious influence, even religion itself, has been seen in command or centralized systems. It seems clear that this argument is more political than factual in terms of establishing structures of government in fundamentalist systems. The result of this fundamentalist perception concerning the incompatibility of market systems and religious value, results in a quest for prestige instead of efficiency. Discussion in patriarchal systems about the importance of establishing effective controls on government gives way to discussion of religious virtue and its unspoken goal of maintaining power in the hands of the religious elite.

#### **D. GOVERNANCE**

While an educated person surely does not require a definition of government it is helpful to review the concepts of governance used by two influential organizations when dealing with this concept. To position the definition of governance away from being simply the "act of governing" to something more concrete is important in understanding the consequences of elements of governance in practice. The Development Assistance Committee (DAC) of the OECD defines governance from a donor perspective as:

...the use of political authority and exercise of control in a society in relation to the management of its resources for social and economic development.<sup>93</sup>

The Development Assistance Committee further identifies three elements of governance which can be used to establish the form of government in use when reviewing a specific nation. These elements include the form of the regime, the process of management of social and

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<sup>93</sup> OECD, Development Assistance Committee, (DAC), "Orientations on Participatory Development and Good Governance," presented in Paris, 1993.

economic resources, and the capacity of government to formulate and implement its policies.<sup>94</sup>

World Bank literature applies the concept of governance to:

...capture and define the interests of both the World Bank and other international institutions in the political and institutional factors affecting structural adjustment.<sup>95</sup>

The definitions of governance used by both the World Bank and the OECD indicate that concepts of governance are applied to situations well beyond direct intervention in economic activity. The moral neutrality of the concept of governance illustrated by these working definitions does not create differences in the application of government designed to meet the common needs of society. While commonality of social value is frequently found to exist within a concept of governance, there is no specific moral imperative for coexistence in most economic systems. It is however, a critical element for proponents of "New Traditional" economies. The importance of the separation between the concept of governance and administration of a nation's morality, is found in the realization that there should be a possibility of establishing a morality neutral system of government.<sup>96</sup> The question of the desirability of such a system is beyond the scope of this paper.

## **E. CONSIDERATIONS**

By most market definitions "good" or "bad" governance is frequently tied to the ability to support efficient markets, usually within a framework derived from common values. Representation of particular elements of governance can greatly effect perceptions of the quality of governance without significantly affecting the nature of the system. Pure market oriented choices are often moderated by political concerns of the policy makers. This political shading does not escape fundamentalist based systems. It seems that even those next to the

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<sup>94</sup> Dhonte, et al. "Towards a Market Economy," p. 10.

<sup>95</sup> Frischtak, Leila and Izak Atiyas, (eds.), *Governance, Leadership, and Communication*, (The World Bank, 1996).

<sup>96</sup> Dhonte, et al. "Towards a Market Economy," p. 10.

seats of power need to rely on the subtlety of political maneuvering. Issues affecting efficiency and long term growth of the economy include topics like the protection of the less fortunate in society, the need to placate constituents, the maintenance of subsidy payments, repayment of international loans, and other deliberate policy choices made by any government. It appears that a foundation of strict religious belief does not excuse the echelons of government from making these often hard choices.

This point, while perhaps obvious to the casual observer, that government must be responsible for reconciling societal needs and economic realities, becomes critical to fundamentalist systems when applied to the roles of religion in society. It seems impossible to reconcile the difficult economic choices of governments and strict adherence to the precepts of religious fundamentalism.<sup>97</sup> For with every economic choice comes an economic winner and a loser. Deciding who these members of a society should be is almost certainly better left to those who do not claim responsibility for providing moral direction and professing complete concern for the well being of man.

To further clarify this point, if religion is to be pure and unhindered by political considerations, that is, free to tend to men's souls without being responsible for their economic status, then it seems clear that the structures of government and religion should be separate.<sup>98</sup> This is not to say that the structures of government cannot be based on the ideals of religion, simply that along with the establishment of such structures should come enforceable rules which then limit the ability of those responsible for defining the structure from applying further influence.<sup>99</sup> This limiting of the application of influence is directly related to creation (of the perception) of stability in a regime.<sup>100</sup>

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<sup>97</sup> Barber, Benjamin, J., *Jihad VS. McWorld: How Globalism and Tribalism are Reshaping the World*, (Random House, New York, 1995) p. 205-216.

<sup>98</sup> *Ibid.*, p 209.

<sup>99</sup> *Ibid.*, p209.

<sup>100</sup> Dhonte, et al. "Towards a Market Economy," p. 10.



While the capacity to ensure economic security is clearly an element of “good” governance and a primary element of this paper, the core of good governance is really a system where the elements of the rule of law (system) hold true. By establishing these elements as indicators of effective government, then potential conflict with the very fabric of the regime can be avoided.<sup>101</sup> By limiting the scope of economic evaluation to elements of the form of the regime, determination of effectiveness and policy judgments can be based on the relative simplicity of the efficiency of markets rather than “complex and insoluble issues of comparative moral superiority.”<sup>102</sup> Avoiding this moral conflict would negate the importance of a call for fundamental changes in the social fabric of society. Once the mantle of morality is removed from what should be economic choices, threats to the foundation of religious fundamentalists are mitigated. By reducing these threats, structures conducive to a rule of law or bureaucratic system may be established.<sup>103</sup>

## **F. CORRUPTION**

Corruption and “bad” governance are often associated, and while corruption is generally bad, the identification and separation of the two is somewhat more complex. In the broadest sense, both corruption and bad governance represent a deviation from the norm. The difference between the two lies in interpretation of the breadth of wrong doing. Corruption is thought of as an individual’s failings, whereas bad structures of governance imply a systemic problem. Differentiation between these oft associated ideas provides two benefits. First of all, by accurately identifying problems, then errors in prescription can be avoided. Secondly, by pointing out differences in the costs imposed on society by either corruption or bad structures governance, it becomes clear that structural elements are much more important in terms of growth.

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<sup>101</sup> Dhonte, et al. “Towards a Market Economy,” p. 9.

<sup>102</sup> Ibid., p. 9.

<sup>103</sup> Barber, *Jihad VS. McWorld*, p. 210.

Corruption is seen to act more like a tax, a cost incurred to conduct business passed on to consumers while supporting some level of bureaucracy, legitimate or not. While corruption is perceived as a local problem, the reality may be that governmental structure is responsible for existence of the problem in the first place.<sup>104</sup> This then implies that corruption is illustrative of bad structures of government. While this is not always true on an individual basis, it seems reasonable to associate rampant corruption in a society with bad structures of governance. It has been said that corruption "is an individual's way around a distrust of government."<sup>105</sup>

The lack of certainty in governmental actions and actors implied by bad structures of government increases investor uncertainty, and thereby reduces stability and economic security. Investors seem to accept that corruption exists and are somewhat willing to absorb the costs if the cost remains constant and predictable. Rapid, often unpredictable governmental actions, however, hold potentially greater costs and investors are less willing to endure these kinds of uncertainties. Attendant consequences of bad structures of governance, reduced certainty and decreased investor confidence, are not necessarily seen when analyzing corruption. Corruption is not inextricably linked to bad structures though it appeals to common sense to anticipate an increase in corruption when in the presence of bad structures of government.

It may appear that this is demonstrably untrue using the example of the U.S. government. The Constitution is one of the great documents of equality and justice in the world but the U.S. government is not free from stupendous corruption. This can be reconciled by application of the very nature of the argument of this thesis that it is the structures of government that are influential in determination of effectiveness of the system, not the foundation of the system itself. To further clarify following this line of thought, one would not argue to rewrite the Constitution to eliminate corruption in the current structures of U.S. government, rather one would attempt to either increase or decrease the level of governmental involvement to find a suitable point from which to operate with minimal corruption and waste.

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<sup>104</sup> Dhonte, et al. "Towards a Market Economy," p. 10.

<sup>105</sup> Stiglitz, Joseph, "On the Economic Role of the State", in *The Economic Role of the State*, A. Heetjé (ed.), (Basil Blackwell, Oxford, 1989).

The correlation to the case of Iran is unmistakable, one would not suggest rewriting the Koran to solve current social and economic problems, rather one would attempt to change existing structures in order to more efficiently meet the direction provided in the sacred text.

#### **G. PRIORITY ISSUES**

The importance of this discussion is not so much in the value of identification of corruption or poor structures of governance, rather to point out topics of immediate priority in addressing economic security. By limiting evaluative focus to these two critical issues, identifying bad structures and establishing priorities, a constructive path towards a market economy can be established without curing all the social ills and theological differences in a society. It seems obvious that a system with a strong basis in fundamentalist religious values stands to benefit greatly from adopting a similar limited, progressive focus in its approach to economic security and growth.

#### **H. TRANSITION**

Transition to a market based economy is a dynamic process rather than an all or nothing proposition. In the course of resolution of this process there exists a multitude of specific economic, social, and political choices which must be undertaken to achieve the goal of economic security. While each system of government will make choices based on historical, religious, social and hopefully economic experience, there are several elements which have proven successful and seem to withstand variance in implementation. These elements include establishment of a structure which has a vested interest in the success of the economy, development of institutions to limit governments discretionary powers, establishment and maintenance of credit-worthiness, and avoiding linkage between the development of market based economic security and general social change.

Through application of the above principles with their demonstrated effectiveness in establishing market based economies, the goal of economic security can or should be able to be established. Once this journey has been completed, or rather embarked on with clear

dedication to the principles required for its success, the question of the goals of economic stability can be addressed. In general this paper accepts the notion that real economic success can be measured in terms of growth. Only through growth or improvements in efficiency can the effects of increasing populations and declining resources be reconciled.



## VII. GROWTH THEORY

The idea that an economic system needs growth to remain or establish itself as successful may seem intuitive to many who live under rule of law systems. Expanding populations, decreasing resources, improved technology and more competitive markets, all point to the necessity for improved social systems facilitated by economic growth. It is only recently that economists have revisited the question of the nature of long term economic growth. The importance of growth is that it is the "fundamental determinant" of whether our children and grandchildren will have better lives and if the world's poor will ascend the economic ladder to move closer to levels of the rich.<sup>106</sup> While some may suggest that growth must be limited to allow room for the youth of the world, they hold no answers for reconciliation of the pressures of increasing social requirements driven by increasing populations. It seems clear that improvements in efficiency manifest as economic growth are the road to success.

Additionally, accurate models about the influence of growth on an economic system can be used to formulate sound economic policies which should lead to successful participation in international markets. This success in international markets combined with the institutions of government which facilitate success should result in an improved distribution of resources and an improved quality of life for many.

### A. SOLOW GROWTH MODEL

The two basic categories of economic growth theory include a traditional model designed in 1956 by Robert Solow, and a model of endogenous growth designed in 1986 by Paul Romer.<sup>107</sup> The Solow model "emphasizes capital accumulation and exogenous rates of change in population and technological progress." This traditional model argues that all market

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<sup>106</sup> Gould, David M., Ruffin, Roy J., "What Determines Economic Growth," in *Economic Review - Second Quarter 1993*, (Federal Reserve Bank of Dallas, Dallas, 1993) p. 25.

<sup>107</sup> *Ibid.*, p. 29.

based economies will eventually reach the same constant growth rate if they have the same rates of technological progress and population growth. Thirty years later, Romer observed that contrary to theoretical explanation, countries, in fact, appear to have accelerating growth rates and these rates differ greatly between countries. From Romer's observations developed the field of endogenous growth, or the idea that long term growth is determined by economic incentive.

The importance of being aware of the implications of these two very different models of growth is founded in the realization that the implied prescriptions for achieving long-term growth are significantly different for each model. By subscribing to one or the other, critical social choices with direct and indirect long term economic consequences are influenced. Without going into a full illustration of both models it is appropriate to briefly review the working points and implied outcomes of each.

## **B. DIMINISHING MARGINAL RETURNS**

The Solow model predicts that the rate of growth of the economy in the long run simply equals the rate of growth in the labor force plus the rate of exogenously determined technological progress.<sup>108</sup> Solow believed that the production function represented constant returns to scale. A doubling of input would result in the doubling of output. However, if one input was held constant, then the doubling of the other would produce less than doubling returns. This is the foundation of the law of diminishing marginal returns, a distinct element of the Solow model.

## **C. INCOME CONVERGENCE**

The Solow model, if accurate, implies good news for developing countries. This model suggests that differences in rates of growth between developing and developed countries is due only to the relative stage of motion towards equilibrium or "steady state." Steady state

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<sup>108</sup> Ibid., p. 28.

is defined as the time when capital stock and level of output are rising at the same rate that the population is growing. In theory, rich countries should grow at a slower pace than poor ones and eventually per capita incomes should converge.

Another assumption of the Solow is the idea that investment in improvements in human capital (accumulated human knowledge) does not increase growth in the long run. This is because, according to Solow, technological progress does not depend on the presence of a skilled work force. Rather, income will rise with the level of physical or human capital but the increase is not self-sustaining. This implies that there is not a correlation between rates of growth and investment in education, a concept difficult to accept in today's technologically oriented markets. This effect of short term improvement is due to an increase in a factor of production and is mirrored in theory concerning the rates of savings. An increase in the rate of savings will affect only GDP and not the long term rate of growth. Saving rate increases will spur a short term increase in the rate of growth due to capital accumulation and increased productivity. However, this short term increase will settle out to equal the rate of change in the labor force plus the rate of technological progress.

These assumptions raise the question of the ability of poor or slow growth country governments to survive until this convergence occurs. If, as Solow predicts, rates of technological change are beyond the influence of governments and improvements in human capital are not able to fuel increasing rates of technological change, then developing nations should be able to invest in areas unrelated to human capital and achieve rates of growth similar to those nations which choose to make this investment. While this has not yet been borne out by statistical evidence, proponents argue that due to similarities found in the hypothesized initial effects of both models, that time will deliver the necessary evidence. Opponents however, contend that the Solow model suffers from its assumptions that technological progress is not explained by economic forces.<sup>109</sup>

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<sup>109</sup> Ibid., p. 29.



#### **D. ENDOGENOUS GROWTH MODEL**

Romer's advances in the field of endogenous growth has produced a theory of economic growth based on the idea that technological progress is driven by economic incentives. Inventions are not the results of pure disinterested scientists operating outside the profit motive. Rather, they are intentional and generate technological spill overs which then contribute to the acceleration of growth by lowering the costs of future innovations.<sup>110</sup> The acceleration of the rate of technological growth postulated by Romer seems to be borne out by even casual observations of developed economies.

What is not as apparent is the realization that application of the Solow model will produce the same or similar effects in the short term. Only when technological progress can be measured will any differences be quantifiable and borne out by statistical review. Measuring of technological progress may require between five and one hundred years depending on which model is used for analysis. Because of the possibility of diminishing marginal returns which allow for an initial surge followed by converging rates of growth, proponents of the Solow model can justify their positions and claim that history will prove them accurate. This paper agrees with proponents of Romer's work and the implication that investment in human capital will provide an accelerating rate of growth.

Recent work in the field of endogenous growth speculates a direct correlation between increased human knowledge and the rate of technological progress. This correlation produces a self sustaining relationship in which the cost of innovation falls as levels of knowledge increase. In this model there is no diminishing return effects on the rate of capital when other factors of production are held constant. This suggests that increased levels of capital will result in increasing rates of growth. So, rates of growth will always be faster among nations which have a large stock of capital, a large educated population or an environment which is favorable to the accumulation of knowledge. The impact of endogenous growth theory to the discussion in this paper is to provide the link between the growth of productivity, hence the economy, to

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<sup>110</sup> Ibid., p. 29.

the structure and policies of the economic system rather than exogenous forces of luck and nature as implied by Solow.

## E. DETERMINANTS OF GROWTH

It is generally accepted that growth is influenced by investment in capital, political and governmental structures, and the trade policy of the country under review. While the impact or relative importance of the component elements of the determinants of growth may be debated there is much less discussion about the composition of these factors. Capital investment must be both physical and intellectual. In terms of government structures this thesis is dealing with the stability and openness of the structures. Trade policies may be viewed from the perspectives of either protectionism or free trade.

The definitive road to enhanced growth has not yet been fully mapped, though materials which seem to positively contribute to long term growth include schooling and investment in education,<sup>111</sup> capital savings and investment,<sup>112</sup> equipment investment,<sup>113</sup> and the level of human capital.<sup>114</sup> Societal and economic choices which seem to hinder long term growth include large government consumption spending,<sup>115</sup> political and social instability,<sup>116</sup> trade barriers,<sup>117</sup> and socialism.<sup>118</sup>

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<sup>111</sup> Barro, Robert J., "Economic Growth in a Cross Section of Countries," *Quarterly Journal of Economics* 106 (May, 1991) pp. 407-43; see also Gregory N. Mankiw, David Romer, and David N. Weil, "A Contribution to the Empirics of Economic Growth," *Quarterly Journal of Economics* 107 (May, 1992) p. 407-37.

<sup>112</sup> Mankiw, et al., "Empirics of Economic Growth" (1992) .

<sup>113</sup> DeLong, J Bradford, and Lawrence H. Summers, "Equipment Investment and Economic Growth," *Quarterly Journal of Economics* 106 (May, 1991) p. 445-502.

<sup>114</sup> Barro (1991), see also David Gould, and Roy J. Ruffin, "Human Capital Externalities, Trade, and Economic Growth," *Federal Reserve Bank of Dallas, Research Paper No. 9301* (Dallas, January, 1993).

<sup>115</sup> Barro, "Economic Growth, Cross Section," (1991).

<sup>116</sup> Ibid.

<sup>117</sup> DeLong and Summers, (1991), Dan Ben-David, , "Equalizing Exchange: A Study on the Link Between Trade Liberalization and Income Convergence" (University of Houston, October, 1991); Nouriel Roubini, and Xavier Sala-i-Martin, "Financial Development, the Trade Regime, and Economic Growth," *NBER Working Paper Series*, no. 3876 (Cambridge, MA. National Bureau of Economic Research, 1991); and Gould and Ruffin (1993).

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<sup>118</sup> Barro, "Economic Growth, Cross Section," (1991).

## VIII. STRUCTURES IN IRAN

It is now time to re-focus to Iran. There has been some measurable impact of U.S. policy on the economic situation in Iran. Rather than discussing the appropriateness, effectiveness, or desirability of the status quo, this paper will attempt to identify the potential for stability based on existing structures of government. It seems that if the theory about structures of government leading towards growth is correct, then evaluation of the credibility, predictability, and structures existing in Iran today can be undertaken with a reasonable chance of constructive output.

### A. EROSION OF SUPPORT

Following the revolution in Iran the structures of government were given a strong Islamic flavor by the new regime. Despite initial popular support for the basis of the regime change, many believe that conditions were better under the previous regime lead by the U.S. supported Shah of Iran. The decline in popular support for the hardships required by the fundamentalist regime are based on the populations perception that the revolutionary regime has mismanaged their responsibilities.<sup>119</sup> Through encouragement of heavy handed enforcement of fundamentalist created injunctions, a declining standard of living which is impacting the middle class, and the inability to maintain popular social programs, support for the effort has been eroded.<sup>120</sup>

This erosion of popular support illustrates a paradox common to repressive regimes, this is that every regime requires some level of public support for its policies, popular or not. Maintenance of the structures of government can not be accomplished by only implementing a

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<sup>119</sup> See Bahram Nowzad's review of Jahangir Amuzegar, *Iran's Economy Under the Islamic Republic*, (I.B. Tauris, New York, 1993), in *Finance and Development*, June, 1994, p.51.

<sup>120</sup> "Bully Boys at Work: Saving the Revolution From Social Corruption" in Survey Iran, *The Economist*, January 18, 1997.

policy of elimination of opposition, a tactic common to regimes attempting to shore up bad structures of government. Attempts to shore up bad structures by eliminating opposition through the application of heavy handed tactics is counterproductive to what should be the goal of the regime, that is embarking on the path towards developing good structures. The fragmented nature of the political structure and the elite has consistently hindered Iran's ability to formulate and implement effective policy.<sup>121</sup> However, this has not deterred the clerics from their practice of continuing their choke hold on the economy.

## **B. CHARITABLE FOUNDATIONS**

The structure in Iran following the revolution has placed great power and enormous wealth in the hands of semi-public charitable foundations.<sup>122</sup> These foundations, called Bonyads, are set up to operate appropriated business for the benefit of various groups in Iran which fall under such blanket descriptions as "the oppressed". In practice, though government owned and under control of the clerics, these Bonyads have come to operate largely outside of government control and accountable to no one.<sup>123</sup> The largest of these foundations, "The Foundation for the Oppressed and Injured" has grown to become 5 times as large as all other foundations combined and the largest conglomerate in the Mid-East.<sup>124</sup> Currently, Iran has only about 14 percent of its GDP in private control. About 1.5 percent of GDP is controlled by the "Bonyad Mostazafan va Janbazan."<sup>125</sup>

What is significant is that Bonyads and other state run banks and industries receive some 62 per cent of allocated expenditures, while these industries have a reputation for

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<sup>121</sup> Ghoreishi, Ahmad, "Iran's Attempts to Circumvent America's Containment Policy," Unpublished, March 1997, p.12. See also Kaplan, "Friends Again," *The Wall Street Journal*, February 10, 1997.

<sup>122</sup> *Islamic Republic of Iran-Recent Economic Developments*, IMF Staff Country Report No. 95/121, the (International Monetary Fund, Washington, D.C., December 1995) p.46.

<sup>123</sup> Barraclough, Colin, "Despite Tradition of Trade Iran has few Entrepreneurs," *The Christian Science Monitor*, April 09, 1997, p. 8.

<sup>124</sup> Ghoreishi, "Iran Circumvent s Containment," p. 21. See also IMF Report No. 95/121, p. 46.

<sup>125</sup> *Ibid.*, p. 23, IMF Report No. 95/121, p. 46.

inefficiency and corruption they, according to President Rafsanjani, "intend to be profitable".<sup>126</sup> The mechanism which allows the government to continue these excessive expenditures on poorly run businesses with little or no motivation to return a profit is a manipulation of exchange rates. By devaluation of the currency every year and increasing revenues by domestic sale of part of its "dollar oil revenues" at the official exchange rate of IR. 3000, revenues can be manipulated to appear to meet expenses.<sup>127</sup> These domestic currency sales are made to primarily to state industries and then to domestic traders who can show a need for foreign currency.

### C. INEFFICIENCY AND CORRUPTION

The impact of the inefficiency of Iran's government can not be understated. The level of involvement of government structures in the daily existence of the population is extensive and largely unwanted.<sup>128</sup> As some 86 percent of the GDP is achieved through government run business the economic impact is also severe.<sup>129</sup> The inefficiency of government structures in terms of running businesses, fuels existing problems with inflation, which ranges between 40 to 200 percent on some basic items.<sup>130</sup> This economic chaos created by conflicting government policies, combined with a lack of competent managers and underworked, underpaid employees, acts to disenfranchise the middle class population. This segment of society which should represent the foundation from which to support the economy and the fundamentalist government, becomes one of its largest threats and burdens.<sup>131</sup>

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<sup>126</sup> Allen, Robin, "Iran: Creative Budgeting the Rule," [www.usa.ft.com](http://www.usa.ft.com), January 30, 1997, p. 2.

<sup>127</sup> *Ibid.*, p. 3.

<sup>128</sup> Hard Times: How not to Attract Investment", in Iran Survey, *The Economist*, January 18, 1997.

<sup>129</sup> Allen, "Creative Budgeting," p. 8.

<sup>130</sup> IMF Report No. 95/121, p. 46, see also Swindells, "Tough Economic Challenges", *Reuters*, May 05, 1997.

<sup>131</sup> Swindells, "Tough Economic Challenges."

As noted above, these changes are often associated with a need to establish or expand individual liberties. These liberties are frequently articulated by the young.<sup>132</sup> Iran certainly has plenty of youth, and while the mantle of religion may placate them for some time, they will begin to ask questions and seek answers.<sup>133</sup> If the structures of government do not or can not provide these answers, not only in terms of theology and ideology but also jobs, homes, families and generally improving standards of living, they will look elsewhere for the answers while holding those who failed them accountable.<sup>134</sup>

#### **D. THE EFFECT ON PRIVATE ENTERPRISE**

To cover the losses from inefficient regime run businesses, government simply sets artificial limits on prices, prints more money, and requires businesses to raise salaries.<sup>135</sup> To protect ineffective workers from separation, the government makes it virtually impossible to lay off workers to compensate for increased efficiency. There is little motivation for managers to find ways to streamline processes and increase profits. According to an official in Iran's Plan and Budget Organization, some 24 percent of the workforce could be laid off with no change in the GDP.<sup>136</sup> The sliver of GDP left to private business, despite President Rafsanjani's pragmatic attempts at privatization, is burdened with the arbitrary nature of the tightly controlled central bank and government agency policies.<sup>137</sup> Frequent changes without cohesive direction have resulted in the growth of unchecked bribery and corruption.<sup>138</sup> This corruption is fueled by business people who desire to achieve some level of stability in order to track their investments. Only through direct financial influence on the policy makers and officials can

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<sup>132</sup> Ibid., p. 100.

<sup>133</sup> Viorst, "Limits of Revolution," p. 64.

<sup>134</sup> Murphy, "Iran on the Rocks," p. 100.

<sup>135</sup> "Iran: Country Update," *EIU ViewsWire*, October 23, 1996. See also EIU: "Country Report: Iran," 3rd Quarter, August 8, 1996, p. 7.

<sup>136</sup> Ghoreishi, "Iran Circumvents Containment," p. 23.

<sup>137</sup> Barraclough, "Iran Has Few Entrepreneurs," p. 8.

<sup>138</sup> Swindells, "Tough Economic Challenges." See also Murphy, "Iran on the Rocks," p. 100.

these business people hope to stay abreast with the rate of policy change generated by the ineffective government structures

This is likely a case where structures of the government are as responsible for the existence of corruption as the individuals themselves. An environment in which corruption and bribery would be effective is often found in systems lacking accountability and strict controls to prevent these actions.<sup>139</sup> Leaving decisions concerning the limits of private business operation to local ministers may actually condone an environment in which these elements of bad structures of government can flourish. Superficially, this seems to indicate a decentralized structure due to the lack of specific controls. Realistically, by preventing establishment of a unified structure for these kinds of decisions, corruption is encouraged. This is not to imply that every individual engaged in these acts of corruption is of evil intent. Rather, due to inefficient channels of communication, a lack of clear policy direction, and a desire to make ends meet, these local officials are able to both benefit the regime and themselves. Additionally, corruption provides an attractive avenue serving to entrench these local policy makers in the decision making process.

#### **E. DEBT, UNITY, CONSENSUS**

One area in which the usually divided government has reached agreement is on the importance of reducing the nation's debt. On reaching this agreement the debt has been refinanced and restructured from short to long and medium term notes which are being repaid in "textbook fashion."<sup>140</sup> The commitment to achieving the goals generated by this unusual consensus is so imbedded in the thinking of the regime that economic decisions in the nation are dedicated to debt repayment.<sup>141</sup>

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<sup>139</sup> Swindells, "Tough Economic Challenges."

<sup>140</sup> Ghoreishi, "Iran Circumvents Containment," p. 15.

<sup>141</sup> Ibid., p. 13.



The importance of this somewhat rare example of consensus in the Iranian leadership, is to illustrate the ability to make effective, radical changes in order to meet national goals. Further this example of consensus indicates that while consensus may be difficult to achieve, once established it does become unifying for the leadership. The response of the government when faced with the realization of the magnitude of the debt crisis is telling. In 1993, Iran was about \$14 billion behind on payments on its \$32 billion debt.<sup>142</sup> With extraordinary zeal and in the face of US opposition, the central bank and government officials struggled to refinance short term notes into long and medium term notes. Assistance from Germany opened the door, and the majority of the rest of Iran's short term debt was refinanced.<sup>143</sup>

To facilitate hard currency needed to meet the refinanced debt burden, Iran has implemented a sharp cutback in imports. To illustrate the magnitude of this cutback, imports have dropped from a high of \$28 billion in 1991- 1992, to a current \$11.5 billion in 1995 - 1996.<sup>144</sup> While this has occurred, debt service obligations have been reduced from \$6.7 billion in 1996 - 1997, to a projected \$4.7 billion in 1997 - 1998. Overall debt has been reduced to about \$23 billion while payments in arrears have been reduced to \$200 million.<sup>145</sup>

#### **F. US OPPOSITION, LIMITED SUCCESS**

Meeting this significant economic challenge was possible despite US opposition because most of the debt was owed to European and Asian trading partners rather than US firms. Asking the tax payers of these other trading partners of Iran to carry the economic burden for US political policy was not a realistic option. This ineffective policy of opposition in the international banking world provided the Iranian regime a public relations coup in terms of evading the impact of US policy.<sup>146</sup> The ability to generate consensus and implement

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<sup>142</sup> Ibid., p. 14. See also IMF Report No. 95/121, p. 38 - 40.

<sup>143</sup> Ibid., p. 14.

<sup>144</sup> "Imports Continue their Downward Spiral," Iran Times, May 10, 1996, p. 15. See also IMF Report No. 95/121, p. 37.

<sup>145</sup> EIU: "Country Report, Iran," 2nd Quarter, May 28, 1996, p. 7.

<sup>146</sup> Ghoreishi, "Iran Circumvents Containment," p. 21.

unpopular policy actions could only be accomplished through regime and national unity. In this case, US opposition provided a common enemy around which to rally. The debt owed to European and Asian firms limited the ability of the US to intervene. The unexpected unity of the Iranian regime allowed, at least temporary, success in the resolution of this finance crisis.

The manner in which the regime was able to weather the debt crisis, by cutting expenses, reducing debt interest loads, establishing a common goal, and providing a national direction was not readily anticipated by most Western analysts. One of the most revealing aspects of the regime is that when pushed into a corner, when action must be taken to ensure its survival, then it seems capable of not only achieving consensus, but also applying lessons provided by the international marketplace. The adaptation of the regime and implementation of these kinds of international lessons clearly shows the pressures driving the regime to consensus. Not only does this illustrate some adroit political maneuvering, it also serves to reinforce some level of regime creditability. Creditability, is a key to good structures of government which are subsequently essential elements of growth.

Despite the ability demonstrated by the regime to meet significant economic challenges, the measures implemented to facilitate the resolution of the debt crisis have brought along their own baggage. Specifically, the recent election points to the disillusionment permeating society concerning the necessity and effectiveness of the radical measures enacted to allow the survival of the regime with little apparent concern for the hardships of the population.

## **G. STRUCTURAL THEORY AND TRANSITION**

To fit this into the theory of the importance of structures of government is not difficult, in fact there is a direct parallel in terms of the hostility of the regime to the winds of change blowing towards establishment of a market system. By shifting to, or establishing a focus on the effectiveness of market structures rather than the moral superiority of one decision over another, the regime may yet be able to transition into an effective structure without completely destroying the present structures. This would seem to be a goal one would assume the ruling clerics and business people ought to find appealing.

One of the two major challenges to be faced in the transition from central planning to market structures is the importance of dealing with the time consistency problem. This occurs when the ruler or rulers have a vested interest in establishing rules which may limit their predatory powers. For only through subjection to such a rule of law system can predictability and creditability be established, paving the way for economic security and growth.

The second element which must be dealt with during the transition from centrally planned systems to market structures is the necessity to deal with the ideological push for individualism and social equality. The growing demands of just the youthful population will continue to place the regime and its clerics under great pressure to produce or make available consumer goods and products.<sup>147</sup> Belt tightening, by significantly restricting imports worked once, but there is little guarantee that today's young people will affirm the necessity of sacrifice to maintain what they may consider an oppressive domestic regime.<sup>148</sup>

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<sup>147</sup> Ibid., p. 100.

<sup>148</sup> Wright, "The Revolution Unravels.", see also IMF Report No. 95/121, p. 46.

## IX. CONCLUSIONS

The case of Iran is unique in the establishing of fundamentalist religious systems. The scope of the effort and the rate at which it was accomplished both serve to reinforce its unique status among developing fundamentalist based systems. While Iran is unique, it is also representative of the goals of most modern fundamentalist based systems in particular. Strictly adhering to religious precepts is considered desirable even in the face of increasing evidence that such attempts are likely to contribute to economic stagnation and slow growth. The idea that there should be some mechanism with which to balance the desire for consumer goods and adherence to religious concepts is persuasive. Unfortunately, there is no system which has been able to demonstrate success in this attempt. Economic reality has made clear that superior morality cannot replace economic efficiency in the marketplace.

At issue is the potential for such fundamentalist systems in general, and in the case of Iran specifically. The application of the theory of the importance of structures of government implies that it is the process which is responsible for establishing one system as more stable than another. If then organization is key, is there any reason why a fundamentalist based system could not establish these structures? The answer appears to be that there is no specific hindrance for a fundamentalist based system which may choose to apply these theories of governance and growth. It seems clear that any system of government with the proper motivation should be able to establish a solid framework for development and maintenance of good structures of government.

Will existing fundamentalist systems choose to pursue this path? This is more difficult to answer. In the case of Iran, it seems that moderate forces are shifting the regime towards less active intervention in the markets. Will the clerics allow this to continue unchallenged? Likely not. Vested interests and an unstable basis for their political, if not religious, positions are unlikely to be mediated any time soon. This seems to leave Iran and perhaps fundamentalist systems in general awash in a sea of possibilities without land in sight. What seems clear, is that the potential should exist for Iranian stability through good structures of

government leading towards growth and modernization. The key to this potential rests with the clerics and their willingness to let go of their strangle hold on the nation's economy.

Decisions which seem to positively contribute to long term growth include schooling and investment in education, capital savings, and expenditures in equipment modernization, and improvements in human capital.<sup>149</sup> Dealing with these elements individually, shows that, in many cases, Iran is in an arguably good position to position itself for future growth. For this to happen problems associated with existing structures of government must be overcome in order to capitalize on the potential strengths of the nation.

The International Monetary Fund (IMF), Middle East Department, chaired by Paul Chabrier, made recommendations to Iran in an effort to provide some clear policy direction for the regime. All of the IMF recommendations include establishing or moving towards a rule of law system and subsequent reliance on the market to drive economic decisions with governmental oversight. These recommendations include: unification of exchange rates, introduction of a value added tax, cutting energy subsidies, liberalizing trade and allowing more autonomy to the central bank.<sup>150</sup> If implemented, Iran could be seen as pursuing a serious effort to stabilize the economic situation and create an environment for growth which would help placate lending banks fears of the fundamentalist regime.<sup>151</sup>

Applying the principles conducive to long-term growth, Iran has a youthful and growing population, underdeveloped natural resources, decreasing debt, a recently elected pragmatist as president, and a location that once served as a major trade route to the East.<sup>152</sup> While the clerical regime is strongly opposed by current US policy, this same policy in practice, has effectively limited US policy options to those resting within the scope of military intervention. Through early recognition of the inevitability and importance of the economic potential of Iran, the US can improve its regional position and influence without decreasing its

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<sup>149</sup> Gould, and Ruffin, "What Determines Growth?", p. 35.

<sup>150</sup> Allen, "Creative Budgeting," p. 3.

<sup>151</sup> Ibid., p. 4.

<sup>152</sup> Kaplan, "Friends Again."

security. Ignoring or underestimating these positive aspects of Iran may leave US policy and business out of position to capitalize on opportunities in the region. Further, as fundamentalist systems continue their world-wide growth, acceptance of the potential for establishing quasi-democratic pro-market structures will be necessary for the West in order to continue their leadership position in the international community. The IMF recent shifted from their position of linking credit to inflation and deficits to one supporting good governance.<sup>153</sup> This change may produce some statistical information to further support the contention of this thesis that structures of government are more important than the form of regime in establishing economic stability.

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<sup>153</sup> Lewis, Paul. "I.M.F. Seeks Argentine Deal Linking Credit to Governance." *The New York Times*, Sec. C, pg. 1, 15 July 1997.



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